



University of Richmond  
**UR Scholarship Repository**

---

Law Faculty Publications

School of Law

---

2005

# Recoupment: Apples, Oranges and Fruit Basket Turnover

David G. Epstein

*University of Richmond*, [depstein@richmond.edu](mailto:depstein@richmond.edu)

Follow this and additional works at: <http://scholarship.richmond.edu/law-faculty-publications>



Part of the [Bankruptcy Law Commons](#)

---

## Recommended Citation

David G. Epstein & Jonathan A. Nockels, *Recoupment: Apples, Oranges and Fruit Basket Turnover*, 58 S.M.U. L. Rev. 51 (2005).

This Article is brought to you for free and open access by the School of Law at UR Scholarship Repository. It has been accepted for inclusion in Law Faculty Publications by an authorized administrator of UR Scholarship Repository. For more information, please contact [scholarshiprepository@richmond.edu](mailto:scholarshiprepository@richmond.edu).

# RECOUPMENT: APPLES, ORANGES AND FRUIT BASKET TURNOVER<sup>1</sup>

David G. Epstein\*  
Jonathan A. Nockels\*\*

“[O]nly apples can be recouped against apples, not apples against oranges. Apples may be *set off* against oranges, but this takes the matter out of the nature of recoupment. . . .”<sup>2</sup>

THIS is an article about the nature of the right of recoupment in bankruptcy. It is not an article about apples or oranges or how to figure out whether a fruit basket is all apples or all oranges. It is instead an article in part about how to distinguish apples from oranges in bankruptcy proceedings, and in part about the fruit basket turnover that can result when the nature of recoupment in bankruptcy is not fully understood.

In sum, we understand the scope of recoupment in bankruptcy to be no different from the scope of recoupment outside of bankruptcy: if it is “apples and apples” outside of bankruptcy, it is “apples and apples” in bankruptcy. And we understand that there are a lot of really smart bankruptcy judges and lawyers and law professors<sup>3</sup> who do not yet share this understanding.

Misunderstanding the nature of the right of recoupment in bankruptcy is understandable. After all, the Bankruptcy Code nowhere uses the term “recoupment” and neither did the Bankruptcy Act of 1898. Nonetheless, reported opinions from proceedings in bankruptcy cases have used the

---

1. Using Westlaw, we could find numerous cases and articles that use the phrase “fruit basket turnover” (or “turn-over”). None of them included any attribution. A website, <http://www.gingergeyer.com/artstories/amosbasket.html>, and an outstanding librarian at the SMU Underwood Law Library, Laura Justiss, traced the phrase to a quotation from Amos 8:1-2, and Caravaggio’s painting, *The Supper at Emmaus*.

\* David Epstein [DE] is a Professor of Law at the Southern Methodist University Dedman School of Law. He is grateful to the Law School for its generous grant and to Jonathan Nockels for his invaluable assistance, both of which made this article possible.

\*\* Jonathan Nockels is the William L. Hutchinson Scholar at the Southern Methodist University Dedman School of Law and is grateful for not paying tuition.

2. *In re Delacruz*, 300 B.R. 669, 683 (Bankr. E.D. Mich. 2003).

3. Including at least one of the co-authors of a classic bankruptcy treatise. 1 DAVID G. EPSTEIN, STEVE H. NICKLES & JAMES J. WHITE, *BANKRUPTCY* § 6-45 (1992) [I know that is a sentence fragment: my 11th grade English teacher, Alice Lindemann (bless her soul) said that I could use sentence fragments after I had a book published. DE].

term "recoupment" for almost seventy years.<sup>4</sup>

The facts and recoupment issues in the most recent United States Court of Appeals decision on recoupment in bankruptcy, *In re Holyoke Nursing Home, Inc.*,<sup>5</sup> are representative.<sup>6</sup> The Chapter 11 debtor, Holyoke Nursing Home, Inc. ("H") operated a nursing home and was a party to a Medicare Provider Agreement with the United States Health Care Financing Administration ("US").<sup>7</sup> Under the agreement, US made advance payments to H based on estimates of costs of services that H provided to Medicare patients, subject to an audit at the end of each fiscal year.<sup>8</sup> If the audit showed that H was paid more than the amount to which it was entitled, then US was authorized by statute to withhold the amount of prior overpayment from subsequent payments or make other arrangements to obtain repayment from H.<sup>9</sup>

In the fiscal year 2000, US determined that it had overpaid H in prior fiscal years and deducted the overpayment from its payments to H during that year. The fiscal year 2000 was also the year that H filed for Chapter 11.<sup>10</sup> H filed an adversary proceeding against US contending that the deductions within four months before H's bankruptcy filing were voidable preferential transfers and that US's deductions after the bankruptcy filing were in violation of the automatic stay.<sup>11</sup> The bankruptcy judge,<sup>12</sup> the district court judge, and a unanimous appellate court panel<sup>13</sup> looked to the law of recoupment to hold that US's reduction of payments was neither a preferential transfer nor a violation of the automatic stay.<sup>14</sup>

A short article discussing, *inter alia*, the First Circuit's opinion in *In re Holyoke Nursing Home, Inc.* concludes, "[o]ld issues continue to arise

4. Stanolind Oil & Gas Co. v. Logan, 92 F.2d 28, 32 (5th Cir. 1937) is the first reported opinion in a bankruptcy case that we found that mentions "recoupment."

5. 372 F.3d 1 (1st Cir. 2004).

6. Looking at reported decisions in bankruptcy cases, it is clear that Medicare overpayment is the most frequently litigated recoupment fact pattern. It should, however, be just as clear that recoupment litigation is not limited to Medicare repayments. See, e.g., *In re B&L Oil Co.*, 782 F.2d 155, 158-59 (10th Cir. 1986) (holding that oil buyer could withhold payment for post-petition deliveries to recoup pre-petition overpayments); *Waldschmidt v. CBS, Inc.*, 14 B.R. 309, 313-14 (M.D. Tenn. 1981) (holding that recording company could recoup pre-petition royalty advances to musician from post-petition record sales).

7. *In re Holyoke Nursing Home*, 372 F.3d at 2.

8. *Id.*

9. See 42 U.S.C. § 1395g(a) (2000).

10. *In re Holyoke Nursing Home*, 372 F.3d at 3.

11. *Id.*

12. *In re Holyoke Nursing Home, Inc.*, 273 B.R. 305, 312 (Bankr. D. Mass. 2002).

13. The First Circuit's opinion was authored by Judge Conrad Cyr who "came to the Court of Appeals after serving with great distinction as a United States Bankruptcy Court judge in Bangor for twenty years," 13 Investiture Speech of Kermit v. Lopez, in ME. B.J. 238, 240 (1998). See also Gerald K. Smith, *Issues in Partnership and Partner Bankruptcy Cases and Reorganization of Partnership Debtors*, 86 ALI-ABA CONTINUING LEGAL EDUCATION, 639, 679 (1996) ("Judge Cyr, one of the most knowledgeable Circuit Court judges as far as bankruptcy matters.").

14. *In re Holyoke Nursing Home*, 372 F.3d at 4.

and be misunderstood. . . .”<sup>15</sup> To understand these “old issues,” we need to (1) understand the non-bankruptcy law origins of the doctrine of recoupment and the non-bankruptcy law differences between recoupment and setoff, (2) remember the language of the Bankruptcy Act of 1898 and the 1978 Bankruptcy Code and the bankruptcy law differences between recoupment and setoff, (3) review the reported opinions that distinguish recoupment in bankruptcy from non-bankruptcy recoupment, and (4) consider the role of transfer of property of the estate in preference law, the role of “equity” in bankruptcy and the role of state law in applying recoupment in bankruptcy.

## I. THE NON-BANKRUPTCY LAW OF RECOUPMENT AND SETOFF

### A. EQUITY ORIGINS

The origins of recoupment are in equity and in common law pleading. As the United States Court of Appeals for the Tenth Circuit stated in *In re B & L Co.*,<sup>16</sup> “Recoupment originated as an equitable rule of joinder. It allowed adjudication in one suit of two claims that otherwise had to be brought separately under the common-law forms of action.”<sup>17</sup>

In his commentaries on equity jurisprudence, Justice/Professor Story, provides the following description of recoupment:

The doctrine of recoupment rests upon the principle that it is just and equitable to settle in one action . . . all claims arising out of the same contract or transaction. . . . It is an innovation upon the strict rules of the common law, sanctioned by the courts for the purpose of doing equity between the parties.<sup>18</sup>

Even more modern descriptions of recoupment continue to refer to it as an “equitable doctrine.”<sup>19</sup>

Most modern descriptions of recoupment have changed “same contract or transaction” to “same transaction.” For example, in *National Cash Register Co. v. Joseph*,<sup>20</sup> the New York Court of Appeals stated:

---

15. Samuel R. Maizel, *An Issue That Just Won't Go Away*, 23 AM. BANKR. INST. J. 34, 45 (2004). According to Mr. Maizel's firm's website:

Mr. Maizel specializes in bankruptcy matters, and related appeals, with an emphasis on health-care and government-contract insolvency issues. His clients include the attorneys general of forty-six states and six territories that are parties to the master settlement agreement with the tobacco industry. Formerly, he represented the federal government in bankruptcy, district, and appellate courts nationwide. He has lectured extensively and been interviewed on television and radio on numerous bankruptcy topics.

See <http://www.pszjyw.com/attorney-profile-30.html> topics.

16. 782 F.2d 155 (10th Cir. 1986).

17. *Id.* at 157.

18. 3 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE § 1878 at 479-80 (14th ed. 1918).

19. See, e.g., TIFD III-X LLC v. Freuhauf Prod. Co., L.L.C., No. Civ. A. 20488-NC, 2004 WL 1517135, at \*4 (Del. Ch. June 29, 2004); *In re Watson*, 778 N.Y.S.2d 658, 659 (N.Y. App. Div. 2004).

20. 86 N.E.2d 561 (N.Y. 1949).

"Recoupment" means a deduction from a money claim through a process whereby cross demands arising out of the same transaction are allowed to compensate one another and the balance only to be recovered. Of course, such a process does not allow one transaction to be offset against another, but only permits a transaction which is made the subject of suit by a plaintiff to be examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole.<sup>21</sup>

This excerpt from *National Cash Register* not only explains what recoupment is but also points out what recoupment is not: "such a process [i.e., recoupment] does not allow one transaction to be offset against another. . . ." <sup>22</sup> There is another process—setoff—which allows one transaction to be offset against another transaction.

## B. RECOUPMENT AND SETOFF

The United States Supreme Court provided the following example and explanation of setoff: "The right of setoff (also called 'offset') allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B, when B owes A.'" <sup>23</sup> Historically, the most common use of setoff has been by banks against borrowers who are also depositors. For example, *D* deposits 100 in *C* Bank. *D* later borrows 60 from *C* Bank. Still later, *D* defaults on the loan. By the exercise of its right of setoff, *C* Bank can reduce *D*'s loan balance to 60 and *D*'s bank account balance to 0. <sup>24</sup>

In a setoff, the mutual debts arise from different transactions and the right of setoff typically arises by reason of statute. In recoupment, both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of the transaction without also meeting its obligations.

Obviously, setoff and recoupment are very similar remedies for the collection of debts outside of bankruptcy. It is not usual for non-bankruptcy courts to recognize that a creditor has right to setoff or recoupment without distinguishing between the two.

---

21. *Id.* at 562 (citations omitted).

22. *Id.*

23. *Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 18 (1995) (quoting *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 529 (1913)). *Strumpf* of course dealt with the difference between a right of setoff and an "administrative hold." *Id.* at 17. The Court never mentions "recoupment." *Reiter v. Cooper*, 507 U.S. 258, 259 (1993), is the only Supreme Court decision involving bankruptcy that mentions recoupment. We will more than mention *Reiter* later in this article. See discussion *infra* Part III.A-B.

24. Changes in Article 9 of the Uniform Commercial Code will probably reduce the importance of setoffs by banks. Banks now can and do obtain security interests in their depositors' bank accounts. See U.C.C. § 9-109 cmt. 16 (2000); see generally Stuart D. Albea, *Security Interests in Deposit Accounts and the Banking Industry's Use of Setoff*, 54 ALA. L. REV. 147 (2002); Ingrid M. Hillinger, David L. Batty & Richard K. Brown, *Deposit Accounts Under the New World Order*, 6 N.C. BANKING INST. 1 (2002).

### 1. Statute of Limitations Cases

There is, however, a substantial body of case law outside of bankruptcy that distinguishes between setoff and recoupment. A line of statute of limitations cases holds that a claim of recoupment is not barred by its own statute of limitations while a setoff claim arising from a different transaction is time-barred.<sup>25</sup>

*Cooper v. Reaves*,<sup>26</sup> is illustrative. Cooper filed a medical malpractice suit against Reaves and later voluntarily dismissed the suit.<sup>27</sup> Just before the running of the relevant statute of limitations, Reaves sued Cooper, alleging malicious prosecution and claiming that money was due him by her on open account.<sup>28</sup> In response, Cooper filed a counterclaim alleging that Reaves breached an implied covenant to treat her in a fair and reasonable manner.<sup>29</sup> Reaves contended that the counterclaim was barred by the statute of limitations.<sup>30</sup> The Alabama Supreme Court distinguished setoff from recoupment to hold for Cooper: "Here Cooper's counterclaim for 'breach of contract' clearly arises out of the same transaction as Reaves' claim on open account, since the contract allegedly breached by Reaves is the same contract Reaves claims Cooper has not paid. Consequently, the counterclaim was not barred by the statute of limitations."<sup>31</sup>

---

25. See, e.g., *Bull v. United States*, 295 U.S. 247, 262 (1935) (allowing an executor to offset the government's claim for an income tax deficiency with a claim for overpayment of estate tax based on the same transaction despite the fact that the limitations period for an action for refund on the estate tax had run, unless the offset was permitted the taxpayer would have been taxed twice on the same transaction based on inconsistent characterizations of the transaction); see also *In re Gober*, 100 F.3d 1195, 1207-08 (5th Cir. 1996); *Cooper v. Reaves*, 365 So. 2d 670, 671 (Ala. 1978); see generally Camilia E. Watson, *Equitable Recoupment: Revisiting an Old and Inconsistent Remedy*, 65 *FORDHAM L. REV.* 691 (1996) (notwithstanding the broad title, Professor Watson revisits only federal tax litigation); Michael E. Chaplin, Note, *Reviving Contract Claims Barred By the Statute of Limitations: An Examination of the Legal and Ethical Foundation for Revival*, 75 *NOTRE DAME L. REV.* 1571 (2000). We particularly like Mr. Chaplin's moral basis for courts treating recoupment different from setoff in applying statutes of limitation:

It seems, almost intuitively, that people ascribe greater weight to some actions than to others. Call it a mental moral ledger. For some reason we distinguish between one action that calls for a response (like a thank you card for a gift) from another that does not (as when we find loose change hidden in the crevices of an old sofa). We feel morally obligated in the first instance to make an appropriate response; however, the second instance—while creating a certain amount of pleasure—does not compel us to act. Similarly, set-off—because it is based on a separate action—is more like the loose change scenario. We would not say that because I found the change, you have a right to part of it just because you lost your watch. In like manner, recoupment is more like the thank you card for the gift. Because the actions flow from the same basic "good," we are more comfortable with importing a moral obligation to that situation.

*Id.* at 1590-91.

26. 365 So. 2d 670 (Ala. 1978).

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.* at 671.

## 2. Sovereign Immunity Cases

There is also a line of sovereign immunity cases relying on the distinction between setoff and recoupment. These cases hold that when a sovereign sues, it waives its immunity as to recoupment claims of the defendant—claims arising out of the same transaction or occurrence—but the sovereign does not waive immunity as to claims which do not meet recoupment's same transaction or occurrence test.<sup>32</sup>

For example, *Frederick v. United States*,<sup>33</sup> the most cited sovereign immunity recoupment case, involved a suit by the Small Business Association to recover on a guaranty. The defendant was allowed to raise as a counterclaim the government's mishandling of the defendant's security interest.<sup>34</sup> In so ruling, the United States Court of Appeals for the Fifth Circuit said:

The distinction between recoupment and set-off has significance where a defendant sued by the United States asserts a claim as to which the government has made no statutory waiver of its sovereign immunity. . . . Our conclusion is that when the sovereign sues it waives immunity as to claims of the defendant which assert matters in recoupment—arising out of the same transaction or occurrence which is the subject matter of the government's suit, and to the extent of defeating the government's claim but not to the extent of a judgment against the government which is affirmative in the sense of involving relief different in kind or nature to that sought by the government or in the sense of exceeding the amount of the government's claims; but the sovereign does not waive immunity as to claims which do not meet the "same transaction or occurrence test" nor to claims of a different form or nature than that sought by it as plaintiff nor to claims exceeding in amount than that sought by it as plaintiff.<sup>35</sup>

## 3. Federal Rule of Civil Procedure 13

In so ruling, both the *Cooper* and *Frederick* courts looked to the body of law on compulsory and permissive counterclaims now embodied in Federal Rule of Civil Procedure 13.<sup>36</sup> There is a significant body of case

---

32. E.g., *FDIC v. Hulsey*, 22 F.3d 1472, 1486-87 (10th Cir. 1994); *Frederick v. United States* 386 F.2d 481, 487-88 (5th Cir. 1967); *contra* *United States v. Iron Mountain Mines, Inc.*, 881 F. Supp. 1432, 1455-56 (E.D. Cal. 1992). The *Iron Mountain Mines* opinion acknowledges that other circuits have followed *Frederick* and concedes that "[w]hen the sovereign sues it waives immunity as to claims of the defendant which assert matters in recoupment—and arising out of the same transaction or occurrence which is the subject matter of the government's suit, and to the extent of defeating the government's claim. . . ." *Id.* at 1455. While critical of the *Frederick* opinion—"the foundation of *Frederick* is shaky at best"—the *Iron Mountain Mines* opinion simply declines to apply recoupment doctrine to a government cost recovery action under CERCLA. *Id.*

33. 386 F.2d 481 (5th Cir. 1967).

34. *Id.* at 484.

35. *Id.* at 487-88 (citations omitted).

36. *Cooper*, 365 So. 2d at 671; *Frederick*, 386 F.2d at 488.

law under Federal Rule of Civil Procedure 13<sup>37</sup> on recoupment and setoff discussing the “arising out of the same transaction” requirement that is a part of both the common law of recoupment and Federal Rule of Civil Procedure 13 (hereinafter “Rule 13”).<sup>38</sup>

Rule 13 originated from the law of recoupment. In dictum, in *Coplay Cement Co., Inc. v. Willis & Paul Group*,<sup>39</sup> Judge Posner writes:

Even before the term “counterclaim” was given currency by the promulgation of the Federal Rules of Civil Procedure in 1938, a defendant could seek to reduce its liability by pleading that the plaintiff owed it money. The plea was called “recoupment” if the plaintiff’s debt to the defendant arose out of the same transaction as the defendant’s liability to the plaintiff, and “setoff” if it did not. So recoupment is the ancestor of the compulsory counterclaim.<sup>40</sup>

Similar statements by way of dicta can be found in other reported cases and in the major treatises on the Federal Rules.<sup>41</sup>

The above quotation regarding recoupment from *Coplay* is dictum because the case involves “an esoteric Indiana statute governing the relations between owners and subcontractors”<sup>42</sup> and raises “fundamental issues . . . concerning the doctrine of setoff.”<sup>43</sup> Perhaps the most interesting dictum in *Coplay* addresses setoff directly:

Although as a procedural device the setoff has been supplanted by the permissive counterclaim, the term is sometimes used in a substantive or remedial sense that is very near to the lay sense of the word, to mean an offset to liability, a netting out of opposing claims.

---

37. FED. R. CIV. P. 13.

38. Compare the common law test for recoupment—“same transaction”—and the Rule 13 test for compulsory counterclaims—“same transaction or occurrence.” The latter would seem broader. “Occurrence” would seem to be something additional to “transaction.”

In the main, the case law under Rule 13 does not distinguish between a “transaction” and an “occurrence.” The leading treatise on the Federal Rules concludes “Most courts, rather than attempting to define the key terms of Rule 13(a) precisely, have preferred to suggest standards by which the compulsory or permissive nature of specific counterclaims can be determined.” 6 CHARLES ALAN WRIGHT, ARTHUR R. MILLER & MARY KAY KANE, FEDERAL PRACTICE AND PROCEDURE § 1410 (2d ed. 1990).

The United States Court of Appeals for the Seventh Circuit uses one term to define the other: “Transaction” within the purview of the compulsory counterclaim rule “may comprehend a series of many occurrences.” *Warshawsky & Co. v. Arcata Nat’l Corp.*, 552 F.2d 1257, 1261 (7th Cir. 1977). See also *Moore v. N.Y. Cotton Exch.*, 270 U.S. 593, 610 (1926) (“Transaction” is a word of flexible meaning. It may comprehend a series of many occurrences. . . .). *Moore* pre-dates Rule 13; it was decided under Equity Rule 30 which contained a “same transaction” test, not a same transaction or occurrence test. *Id.* at 609.

And, in the main, the case law under recoupment looks to Rule 13 cases without discussing whether the cases were “same transaction” cases or “same occurrence” cases. *E.g.*, *FDIC v. Hulsey*, 22 F.3d 1472, 1486-87 (10th Cir. 1994); *Frederick*, 386 F.2d at 487-88.

39. 983 F.2d 1435 (7th Cir. 1993).

40. *Id.* at 1440.

41. See, e.g., *Berger v. City of North Miami*, 820 F. Supp. 989, 992 (E.D. Va. 1993); 6 CHARLES ALAN WRIGHT, ARTHUR R. MILLER & MARY KAY KANE, FEDERAL PRACTICE AND PROCEDURE § 1401 (2d ed. 1990).

42. *Coplay*, 983 F.2d at 1435.

43. *Id.*



. . . Setoff survives as a distinctive doctrine—something different from a permissive counterclaim, on the one hand, or a name for the netting of opposing claims, on the other hand—only in banking and in bankruptcy. In the banking industry, setoff denotes a security interest that the law recognizes by allowing the bank to deduct the depositor's debt to it before other creditors can reach the account. And the Bankruptcy Code contains a complex provision regulating the rights of debtors of a bankrupt to set off the debts of the bankrupt to them.<sup>44</sup> Although the doctrine of setoff has an equitable lineage—it dates back to the seventeenth-century chancery court's jurisdiction over bankruptcy—it was grafted onto the common law by statute in the eighteenth century. By the time it turned into the permissive counterclaim, it had lost all of its equitable foliage. Only in banking and in bankruptcy, the two contexts in which as we said setoff retains its substantive or remedial distinction, do equitable considerations sometimes surface. . . .<sup>45</sup>

This statement about setoff raises two significant recoupment questions. First, if setoff has been supplanted by the permissive counterclaim only as a "procedural device," has recoupment been supplanted by the compulsory counterclaim only as a "procedural device?" In other words, is there a body of recoupment law independent of Rule 13? Second, if setoff is a "distinctive doctrine in bankruptcy," is recoupment also a "distinctive doctrine in bankruptcy?"

In *Berger v. City of North Miami*,<sup>46</sup> a statute of limitations case like *Cooper*, a federal district court for the Eastern District of Virginia provides answers to the first question:

[I]t is apparent that there is a marked resemblance between the recoupment doctrine and compulsory counterclaims under Rule 13(a), Fed. R. Civ. P. Nor is this accidental; recoupment is the common law precursor to the modern compulsory counterclaim. Yet, the recoupment doctrine is more than a precursor; it has survived the codification of compulsory counterclaims and enjoys continuing vitality today as a means of asserting an otherwise time-barred counterclaim.<sup>47</sup>

This first excerpt from the district court opinion in *Berger* arguably supports the proposition that there is a body of recoupment law independent of Rule 13.

The district court opinion in *Berger* then proceeds to look to Rule 13 case law in determining whether recoupment was appropriate—whether state law contract claims arise from the "same transaction" that formed the basis for North Miami's CERCLA counterclaim:

Instructive in this regard is the test employed in the Rule 13(a), Fed. R. Civ. P., context to ascertain whether a counterclaim is compul-

---

44. See 11 U.S.C. §§ 506(a), 553.

45. *Id.* at 1440-41 (citations omitted).

46. 820 F. Supp. 989 (E.D. Va. 1993).

47. *Id.* at 992.

sory, i.e., whether it arises from the “same transaction or occurrence” as the main claim. Indeed, given the relationship and essential similarity between compulsory counterclaims and recoupment claims, there is no reason to refrain from using the Rule 13(a) standard to test whether a claim meets the first leg of the recoupment test. In addition, use of this standard is consistent with policy considerations relating to the just and expeditious resolution of CERCLA cases. This standard ensures that collateral matters are not joined with the CERCLA action so as to result in unwarranted expense and delay in resolution of the CERCLA claim. Under the Rule 13(a) standard, the following factors must be examined: (i) whether issues of fact and law raised by the claim and counterclaim are largely the same; (ii) whether substantially the same evidence bears on both claims; and (iii) whether any logical relationship exists between the two claims. Application of this standard to the contract claims asserted here compels the conclusion that they do not arise from the same transaction as North Miami’s counterclaim. As such, they are not valid recoupment claims.<sup>48</sup>

This second excerpt from the *Berger* opinion arguably supports the proposition that not only did Rule 13(a) originate from the law of recoupment but that the law of recoupment has, at least in part, evolved into the law of Rule 13(a). And similar statements can be found in other reported opinions, including opinions arising in bankruptcy cases. Before we take a look at those bankruptcy cases, let’s review the non-bankruptcy law of recoupment and overview the bankruptcy law of recoupment.

In review, there is a substantial body of non-bankruptcy law of recoupment. While many of the recoupment cases arose before Rule 13, many of the cases since the promulgation of Rule 13(a) refer to, if not rely on, cases arising under Rule 13. And, it is a substantial body of law that consistently applies a “same transaction” test (even though the application of that test from case to case may or may not be entirely consistent).

## II. BANKRUPTCY STATUTES AND SETOFF AND RECOUPMENT

### A. SETOFF AND RECOUPMENT UNDER BANKRUPTCY ACT OF 1898

#### 1. *Language of Act*

Section 68 of the Bankruptcy Act of 1898 was entitled “Set-Offs and Counterclaims” and recognized the right of setoff: “In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other,

---

48. *Id.* at 992-93 (citations omitted); *see also* United States v. Ownbey Enter., Inc., 780 F. Supp. 817, 820 (N.D. Ga. 1991) (equating recoupment claim to compulsory counterclaim); United States v. Isenberg, 110 F.R.D. 387, 391 (D. Conn. 1986) (applying Rule 13(a) test in determining whether recoupment counterclaim arose from “same transaction” as main claim).

and the balance only shall be allowed or paid.”<sup>49</sup>

Note that the language of section 68 does not include the word “recoupment.”<sup>50</sup> There is no section of the Bankruptcy Act of 1898 that includes the word “recoupment.”<sup>51</sup>

Note also that the language of section 68 includes the verb “shall.”<sup>52</sup> Notwithstanding Congress’s use of the mandatory “shall” rather than the permissive “may,” “it has been stated frequently that the privilege of set-off under section 68a is permissive and not mandatory, and that the application when invoked, before a court rests in the discretion of, that court, which exercises such discretion under the general principles of equity.”<sup>53</sup>

## 2. *Case Law Applying the Language of Section 68 of Bankruptcy Act of 1898*

One of the cases that so states, *Stanolind Oil & Gas Co. v. Logan*,<sup>54</sup> is the first United States Court of Appeals decision under the Bankruptcy Act of 1898 that mentions “recoupment.” *Stanolind Oil* involved leases belonging to an oil company, Virginia Oil & Refining Company (“VOR”) that was adjudicated bankrupt in an involuntary case in 1923.<sup>55</sup> In his final accounting, the trustee reported “that there were a great many leases in the assets of said estate, which were all wild cat, and which your trustee, using his best efforts, endeavored to sell but was absolutely unable to do so, and, although he still holds same, they are, in his opinion worthless.”<sup>56</sup> The estate was closed; VOR did not receive a discharge.<sup>57</sup>

In 1930, three things happened: (1) oil was discovered in that part of East Texas, (2) one of VOR’s creditors sued in state court and had a receiver appointed, and (3) the state court receiver sold VOR leases to Simms Oil Company (“SOC”). Thereafter VOR’s bankruptcy was reopened and the bankruptcy trustee sued SOC to recover the leases.<sup>58</sup>

SOC argued that the leases had been abandoned. In the alternative, SOC argued “for reimbursement of expenses . . . in the lease.”<sup>59</sup> The district court ruled adversely to SOC on both arguments. The United States Court of Appeals for the Fifth Circuit affirmed as to abandonment but reversed “[i]n so far as the judgment appealed from denies appellants

49. Act of July 1, 1898, ch. 541, § 68, 30 Stat. 544, 565, *repealed by* Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-151326.

50. *See generally id.*

51. *See generally id.*

52. *See generally id.*

53. 4 COLLIER ON BANKRUPTCY ¶ 68.02, at 851-52 (14th ed. 1978) (citing to cases which cite to the Collier treatise). A similar statement can be found in HENRY BLACK, HANDBOOK ON THE LAW OF BANKRUPTCY 380 (1914) (“This provision of the Bankruptcy Act is regarded as permissive, rather than mandatory.”); *see also* *Stanolind Oil & Gas Co. v. Logan*, 92 F.2d 28, 32 (5th Cir. 1937).

54. 92 F.2d 28 (5th Cir. 1937).

55. *Id.* at 29-30.

56. *Id.* at 30.

57. *Id.*

58. *Id.* at 29.

59. *Id.*

a recovery by way of *set-off* for the amount expended for development and operation of the lease. . . .”<sup>60</sup> Before so ruling, the appellate court said the following about section 68, set-off and recoupment: “The doctrine of set-off and recoupment is recognized by the National Bankruptcy Act, Section 68. The provisions of section 68 are permissive rather than mandatory. . . .”<sup>61</sup>

Like our former President, focus on the word “is.”<sup>62</sup> Note that the language of the Bankruptcy Act is not “doctrines of set-off and recoupment *are*” but “doctrine of set-off and recoupment *is*.” Grammatically, the Fifth Circuit in *Stanolind Oil* is treating set-off and recoupment as a single doctrine. Legally, courts, including the Fifth Circuit, generally treat set-off (or setoff) and recoupment as separate doctrines.<sup>63</sup>

And, note also in the first excerpt from the *Stanolind Oil* opinion, the ruling as to SOC’s “recovery by way of set-off.” While *Stanolind Oil* is the first circuit court opinion under the Bankruptcy Act of 1898 to mention “recoupment,”<sup>64</sup> it is a set-off case, not a “recoupment” case.<sup>65</sup>

*In re Monongahela Rye Liquors, Inc.*,<sup>66</sup> the next circuit court opinion under the Bankruptcy Act of 1898 that mentions “recoupment” does not mention *Stanolind Oil*. It does mention section 68 and states by way of dictum:

“[R]ecoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff’s action is grounded.” The rule of recoupment in bankruptcy derives from the rule that the trustee takes the bankrupt’s property subject to the equities therein. It does not attach by reason of the set-off provisions of Sec. 68.<sup>67</sup>

While the *Monongahela Rye Liquors* dictum on whether Bankruptcy Act section 68 covers both set-off and recoupment is different from the dictum in *Stanolind Oil*, both cases are set-off cases, not recoupment cases.<sup>68</sup>

60. *Id.* at 32 (emphasis added).

61. *Id.* (emphasis added).

62. *Cf.* BOB BARR, THE MEANING OF “IS”: THE SQUANDERED IMPEACHMENT AND WASTED LEGACY OF WILLIAM JEFFERSON CLINTON (2004).

63. *E.g., In re United States Abatement Corp.*, 79 F.3d 393, 398 n.16 (5th Cir. 1996) (“The doctrine of recoupment is similar to but distinct from the legal and equitable principle of ‘setoff!’”); *State ex rel. Key W. Retaining Sys., Inc. v. Holm II, Inc.*, 59 P.3d 1280, 1291 (Or. App. 2002) (“‘Recoupment,’ ‘setoff’ and ‘counterclaim’ are not synonymous terms.”). A district court in *Waldschmidt v. CBS, Inc.*, 14 B.R. 309, 314 n.3 (M.D. Tenn. 1981), describes *Stanolind Oil* as “simply incorrect” and adds “a distinction between recoupment and set-off has been universally recognized. To equate them, as the Fifth Circuit seems to have done and as the trustee would have this Court do, would fly in the face of both established authority and common logic.”

64. *Stanolind Oil*, 92 F.2d at 32.

65. SOC’s claim for reimbursement of improvement expenses did not arise from the same transaction as the trustee’s claim for the return of the leases.

66. 141 F.2d 864 (3d Cir. 1944).

67. *Id.* at 869 (quoting *Bull v. United States*, 795 U.S. 247, 262 (1935)).

68. *Id.*

The other circuit court opinion under the Bankruptcy Act of 1898 that mentions both "recoupment" and section 68, *Quittner v. Los Angeles Steel Casting Co.*,<sup>69</sup> does not mention either *Stanolind Oil* or *Monongahela Rye Liquors*. And, the mention of "recoupment" and section 68 again is dictum and occurs in a footnote:

Where the matter is one of recoupment or defense, a defendant need not rely upon § 68(a), because he would merely be proving that he is not liable in full for the plaintiffs claim. 4 Collier on Bankruptcy, § 68.03, p. 714 (14th ed. 1942); 4 Remington on Bankruptcy, § 1435, p. 160 (5th ed. 1943).<sup>70</sup>

There is a district court opinion, *Waldschmidt v. CBS, Inc.*,<sup>71</sup> that covers the question of whether Bankruptcy Act section 68 covers recoupment at greater length as an integral part of holding that CBS was able to recoup money advanced to the great<sup>72</sup> George Jones before his bankruptcy from royalties that CBS owed to George Jones from post-bankruptcy sales:

The trustee attempts to argue that CBS must proceed with its claim under the restrictive set-off provisions of section 68 of the Bankruptcy Act, instead of possessing a general right of recoupment. . . . The trustee is sorely mistaken on both points. . . . [T]he recoupment process is different from the requirements for set-off. While set-off under section 68 is limited to instances involving mutuality of obligation, recoupment is subject to no such limitation. The only real requirement regarding recoupment is . . . arising out of the same transaction as the original sum.<sup>73</sup>

In sum, only three circuit court opinions under the Bankruptcy Act of 1898 addressed the question of whether section 68a of the Bankruptcy Act of 1898, which mentioned only setoff, also covered recoupment. Two of the three circuits, and as indicated above, the two major bankruptcy treatises<sup>74</sup> concluded that the word "set-off" as used in section 68a did not include "recoupment."

## B. RECOUPMENT AND SETOFF UNDER THE BANKRUPTCY CODE OF 1978

### 1. Language of the Code

Unlike the Bankruptcy Act of 1898, the Bankruptcy Code of 1978 uses the term "setoff" instead of "set-off."<sup>75</sup> And, unlike the Bankruptcy Act

69. 202 F.2d 814 (9th Cir. 1953).

70. *Id.* at 816 n.3.

71. 14 B.R. 309 (M.D. Tenn. 1981).

72. It just doesn't get any better than "He Stopped Loving Her Today," lyrics available at <http://www.breakup-songs.com/georgejones.html>.

73. *Waldschmidt*, 14 B.R. at 313-14.

74. See also 2 DANIEL COWENS, BANKRUPTCY LAW AND PRACTICE 121-122 (2d ed. 1978) ("Recoupment dealing with diminishment of a claim due to something arising out of the same transaction is not dealt with as such by section 68.").

75. Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-151326 (2000).

of 1898, the Bankruptcy Code of 1978 uses the term “setoff” in more than one section.<sup>76</sup> Most importantly, section 553 recognizes the right of set-off.<sup>77</sup> If a right of setoff exists under non-bankruptcy law, then section 553 generally validates the non-bankruptcy right of setoff in bankruptcy and protects it from invalidation or avoidance under other sections of the Bankruptcy Code.<sup>78</sup> Additionally, section 362(a)(7) stays the setoff of a prepetition debt owing to the debtor against any claim against the debtor.<sup>79</sup>

Like the old Bankruptcy Act, the present Bankruptcy Code does not use the word “recoupment.” Accordingly, the question of whether the statutory term “setoff” includes “recoupment” is of continuing practical significance.

## 2. *Legislative History*

There is no mention of “recoupment” in the legislative history for section 553. The report, which accompanied the bill which became the 1978 Bankruptcy Code, simply states, “This section preserves, with some changes, the right of setoff in bankruptcy cases now found in section 68 of the Bankruptcy Act.”<sup>80</sup>

## 3. *Cases Applying the Language of Sections 553 and 362(a)(7)*

While legislative history is not helpful in answering the question whether the word “setoff” in the Bankruptcy Code of 1978 includes “recoupment,” case law is. Reported opinions consistently state and hold that the word “setoff” in sections 553 and 362(a)(7) does not include recoupment. The following statement from *In re Malinowski*,<sup>81</sup> a 1998 Second Circuit opinion is representative:

The distinction between set-off and recoupment is crucial because set-off claims are subject to the automatic stay of 11 U.S.C. § 362 and are substantively limited by the Bankruptcy Code, 11 U.S.C. § 553 (1994). Recoupment, in contrast, comes into bankruptcy law through the common law, rather than by statute, and is not subject to the limitations of section 553 or the automatic stay. The automatic stay is inapplicable, because funds subject to recoupment are not the debtor’s property.<sup>82</sup>

Similar statements as to the differences in Bankruptcy Code treatment of setoff and recoupment can be found in opinions from the First,<sup>83</sup>

---

76. See, e.g., 11 U.S.C. §§ 362(b), 365(1)(2), 546(h), 553.

77. 11 U.S.C. § 553.

78. 11 U.S.C. § 553(a).

79. 11 U.S.C. § 362(a)(7).

80. H. R. REP. NO. 95-595, at 345 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6333.

81. 156 F.3d 131 (2d Cir. 1998).

82. *Id.* at 133 (citations omitted).

83. See *United Structures of Am., Inc. v. G.R.G. Eng’g S.E.*, 9 F.3d 996, 998 (1st Cir. 1993).

Third,<sup>84</sup> Fifth,<sup>85</sup> Eighth, Ninth,<sup>86</sup> and Tenth<sup>87</sup> Circuits, and opinions from district courts or bankruptcy courts in other circuits.<sup>88</sup>

### III. DISTINGUISHING RECOUPMENT IN BANKRUPTCY FROM RECOUPMENT IN NON-BANKRUPTCY LITIGATION

It is not the statements from the *Malinowski* opinion and opinions from other circuits about the differences in the Bankruptcy Code's treatment of setoff and recoupment that are problematic. Rather, it is statements in the *Malinowski* opinion and some opinions from other circuits about the differences in recoupment in bankruptcy and outside of bankruptcy that need to be examined—statements such as:

The definition of "transaction" has been developed in the context of determining whether counterclaims are compulsory or permissive under the rules of civil procedure. In this context a transaction "may comprehend a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship." However, in recoupment in bankruptcy, the term "transaction" is given a more restricted definition. See *McMahon*, 129 F.3d at 97 ("In light of the Bankruptcy Code's strong policy favoring equal treatment of creditors and bankruptcy court supervision over even secured creditors, the recoupment doctrine is a limited one and should be narrowly construed.").<sup>89</sup>

In the portion of the *Malinowski* opinion set out above, the Second Circuit seems to provide two reasons for a more restricted definition of recoupment in bankruptcy than in non-bankruptcy litigation: (1) the impact of Rule 13 on the non-bankruptcy law of recoupment and (2) the impact of bankruptcy policy of equal treatment of creditors on the bankruptcy law of recoupment.

#### A. FEDERAL RULE OF CIVIL PROCEDURE 13 AND RECOUPMENT IN BANKRUPTCY

The use of Rule 13 and the use of recoupment in bankruptcy both turn on a "same transaction" test. The Second Circuit in *Malinowski* properly questions whether "same transaction" should mean the same thing in both contexts.<sup>90</sup>

---

84. See *Lee v. Schweiker*, 739 F.2d 870, 875 (3d Cir. 1984).

85. See *In re McConnell*, 934 F.2d 662, 667 (5th Cir. 1991).

86. See *In re Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1398 (9th Cir. 1996).

87. See *In re Peterson Distrib., Inc.*, 82 F.3d 956, 959-60 (10th Cir. 1996).

88. See, e.g., *In re Nu-Kote Holding, Inc.*, 257 B.R. 855, 864-65 (Bankr. M.D. Tenn. 2001); *In re Graves*, 234 B.R. 149, 150 (Bankr. M.D. Fla. 1999); *In re Pearson Indus., Inc.*, 142 B.R. 831, 849 (Bankr. C.D. Ill. 1992).

89. *Malinowski*, 156 F.3d at 133 (citations omitted).

90. *Id.*

In summarizing the Rule 13 case law on "same transaction," the leading treatise on federal practice and procedure concludes: "Courts generally have agreed that these words should be interpreted liberally in order to further the general policies of the federal rules and carry out the philosophy of Rule 13(a)."<sup>91</sup>

A court in a bankruptcy case is not charged with advancing the "general policies of the federal rules" and carrying out the "philosophy of Rule 13." Unless it is applying Rule 13.<sup>92</sup>

As the Supreme Court noted in a footnote in *Reiter v. Cooper*:<sup>93</sup>

For purposes of applying the Federal Rules of Civil Procedure governing counterclaims, it does not matter that this action arose in bankruptcy. Rules 8 and 54 are made fully applicable in adversary proceedings by Bankruptcy Rules 7008 and 7054, and Rule 13 is made applicable with only minor variation (not relevant here) by Bankruptcy Rule 7013.<sup>94</sup>

This Supreme Court dictum in *Reiter v. Cooper* does not however mean that "same transaction" has the same meaning in recoupment litigation arising under Bankruptcy Code section 362(a)(7) or section 553 that it has in litigation under Bankruptcy Rule 7013 or Federal Rule 13.<sup>95</sup> To the extent that reported cases on "same transaction" in applying Rule 13 reflect the "general policies of the federal rules" or carrying out the "philosophy of Rule 13" those cases may not be helpful in determining "same transaction" in applying the Bankruptcy Code which has different "general policies."<sup>96</sup>

91. 6 CHARLES ALAN WRIGHT, ARTHUR R. MILLER & MARY KAY KANE, *FEDERAL PRACTICE AND PROCEDURE* § 1410 (2d ed. 1990). Like the Collier treatise, Wright, Miller & Kane cite cases that cite the treatise to support the treatise.

92. Another one of those sentence fragments. Again, do not blame this on co-author Nockels or the law review editor. Again, Ms. Lindemann is responsible. See *supra* note 2.

93. 507 U.S. 258 (1993).

94. *Id.* at 265 n.2. But cf. Craig H. Averch & Blake L. Berryman, *Getting Out of the Code: When Equitable Remedies Obtain Priority Over General Unsecured Claims*, 5 J. BANKR. L. & PRAC. 285, 300 (1996) ("Bankruptcy Rule 7013, which generally incorporates Federal Rule of Civil Procedure 13's treatment of counterclaims, makes an exception for a nondebtor's claim that arose on or before entry of the order for relief. Such a claim is not a compulsory counterclaim, even if it arose from the same transaction as the estate's claim against the nondebtor. Accordingly, Bankruptcy Rule 7013 makes clear that prepetition claims should not be afforded special treatment merely because such claims would be characterized, outside of bankruptcy, as compulsory counterclaims. The Supreme Court did not discuss this point.").

95. But cf. Peter R. Roest, *Recovery of Medicare and Medicaid Overpayments in Bankruptcy*, 10 ANNALS HEALTH L. 1, 46 (2001) ("[T]he Court [in *Reiter*] found no difference between the right of recoupment in bankruptcy and the ability to assert a compulsory counterclaim in district court under the Federal Rules of Civil Procedure.").

In the brief for the appellant in *Dewey Freight*, this quotation from *Reiter* is used to support the proposition that "the Court found no difference between the right of recoupment in bankruptcy and the ability of any defendant to assert a compulsory counterclaim under Federal Rule of Civil Procedure 13 in any district court." Brief for Appellant at 28. The Eighth Circuit opinion did not even use a footnote to address this argument. See *United States v. Dewey Freight Sys., Inc.*, 31 F.3d 620 (8th Cir. 1994).

96. Without quoting from or even discussing *Reiter*, the Third Circuit concluded:



## B. IMPACT OF BANKRUPTCY POLICY FAVORING EQUAL TREATMENT OF CREDITORS

There is a bankruptcy policy that can be "inelegantly" described as favoring equal treatment of creditors. We will describe that policy more elegantly in the next part of the paper.

Recall from the language of the *Malinowski* opinion that the Second Circuit looks to the bankruptcy policy favoring equal treatment of creditors in calling for a "more restrictive" definition of "same transaction," i.e., a more restrictive concept of recoupment in bankruptcy cases than in other cases.<sup>97</sup> Similar language can be found in other reported decisions from circuit courts and lower courts.

Consider for example, *In re Peterson Distributing, Inc.*,<sup>98</sup> a Tenth Circuit case involving the bankruptcy of a gas distributor ("Debtor") with a Jobber Franchise Agreement with Conoco. Conoco agreed to (1) sell products to the Debtor on credit; and (2) accept credit card invoices from the Debtor and pay the Debtor the face amounts of the invoices, less a three percent processing fee.<sup>99</sup> At the time the Debtor filed its Chapter 11 petition, it owed Conoco more than \$245,000 for Conoco products purchased on credit from Conoco; Conoco in turn owed the Debtor almost \$23,000 for prepetition credit card receipts. After bankruptcy, Debtor generated an additional \$46,561 of credit card receipts.<sup>100</sup>

In an adversary proceeding, Conoco asserted a right to setoff or recoup both the prepetition and post-petition credit card receipts—\$69,370—against its claim of \$245,159. The bankruptcy court held that recoupment

---

We find that the open-ended standard, endorsed in the context of discerning compulsory counterclaims, is inadequate for determining whether two claims arise from the same transaction for the purposes of equitable recoupment in bankruptcy. Indeed, in *Lee* we stressed that both setoff and recoupment play very different roles in bankruptcy than in their original roles as rules of pleading.

*In re Univ. Med. Ctr.*, 973 F.2d 1065, 1081 (3d Cir. 1992).

In *In re TLC Hosp., Inc.*, 224 F.3d 1008, 1014 (9th Cir. 2004), the Ninth Circuit quotes from the *Univ. Med. Ctr.* opinion but does "not accept the Third Circuit's narrow definition of 'transaction.'" Instead, the Ninth Circuit looks to the "logical relationship" test adopted by the United States Supreme Court in *Moore v. N.Y. Cotton Exch.*, 270 U.S. 593, 610 (1926). *Id.* at 1012.

*Moore* is an antitrust case that has no direct application to recoupment in bankruptcy. *Moore* (the case) does, however, have a direct relationship to Rule 13. MOORE (the treatise) explains that, in applying Rule 13's "same transaction" test, "the federal courts have constructed analyses using as their foundation the logical relationship test as developed by the Supreme Court." 3 JAMES WM MOORE, MOORE'S FEDERAL PRACTICE § 13.01[1][b] (2004).

In sum, the Ninth Circuit uses the Rule 13 test for "same transaction" in determining whether there is a right of recoupment in bankruptcy cases.

And, other circuit courts have looked to the Rule 13 test for "same transaction" in determining whether there is "same transaction" as the phrase is used in section 106(b). *E.g., In re Gordon Sel-Way, Inc.*, 270 F.3d 280, 287 (6th Cir. 2001); *Burlington, N.R.R. v. Strong*, 907 F.2d 707, 711 (7th Cir. 1990).

97. *Malinowski*, 156 F.3d at 133.

98. 82 F.3d 956 (10th Cir. 1996).

99. *Id.* at 958.

100. *Id.* at 958-59.

did not apply and that Conoco was limited to setoff of the almost \$23,000 of prepetition credit card receipts.<sup>101</sup> The district court reversed, holding that Conoco was entitled to recoup the entire \$69,370 and the Tenth Circuit then ruled that the bankruptcy court was correct.<sup>102</sup> In so ruling, the Tenth Circuit focused on the “same transaction” requirement and the bankruptcy policy of equal treatment of creditors: “Recoupment is ‘narrowly construed’ in bankruptcy cases because it violates the basic bankruptcy principle of equal distribution to creditors. . . . Therefore, for the purposes of recoupment, ‘same transaction’ is a term of art that must be narrowly defined.”<sup>103</sup>

The Tenth Circuit’s opinion in *Peterson Distributing* nowhere mentions the one Supreme Court opinion that mentions recoupment in bankruptcy, *Reiter v. Cooper*.<sup>104</sup> The “Cooper” in *Reiter v. Cooper* was a bankruptcy trustee for a trucking company suing a customer, Reiter, for freight undercharges. Reiter counterclaimed that the tariff rates were unreasonable. Writing for the majority, Justice Scalia described the question presented by the case as

. . . whether, when a shipper [Reiter] defends against a motor common carrier’s [Cooper] suit to collect tariff rates with the claim that the tariff rates were unreasonable, the court should proceed immediately to judgment on the carrier’s complaint without waiting for the Interstate Commerce Commission (ICC) to rule on the reasonableness issue.<sup>105</sup>

While most of the opinion deals with the Interstate Commerce Act (ICA), the Court also dealt with recoupment in bankruptcy. Under the ICA, challenges to the reasonableness of tariff rates must be pursued within two years after the claim accrues.<sup>106</sup> Reiter had waited too long to bring his own civil action. Recoupment claims, however, are not barred by a statute of limitations as long as the main action is timely.<sup>107</sup> Accordingly, the facts of *Reiter* and the language of the *Reiter* opinion address the issue of recoupment in a bankruptcy context.<sup>108</sup>

Additionally, *Reiter* mentions the bankruptcy policy of favoring equal treatment of creditors, albeit somewhat obliquely in dictum in a footnote: “Recoupment permits a determination of the ‘just and proper liability on the main issue’ and involves ‘no element of preference.’” 4 Collier on Bankruptcy para. 553.03, p. 553-17 (15th ed. 1991).<sup>109</sup>

The Ninth Circuit’s opinion in *Newbery Corp. v. Fireman’s Fund Insur-*

---

101. *Id.* at 958.

102. *Id.*

103. *Id.* at 959-60 (citations omitted).

104. 507 U.S. 258 (1993).

105. *Id.* at 260.

106. 49 U.S.C. § 14705(c) (2000).

107. *See Bull v. United States*, 295 U.S. 247, 262 (1935).

108. *Reiter*, 507 U.S. at 258.

109. *Id.* at 265 n.2. .

ance Co.,<sup>110</sup> is the only circuit court opinion that has expressly relied on this language from *Reiter*. In *Quittner v. Los Angeles Steel Casting Co.*, an earlier, pre-*Reiter* decision, the Ninth Circuit had denied recoupment because "it would interfere with the ratable distribution of assets among the general creditors."<sup>111</sup>

While this language from the Ninth Circuit's opinion in *Quittner* is consistent with the language from the Tenth Circuit's opinion in *Peterson Distributing*, the Ninth Circuit in *Newbery* ruled that it was "inconsistent"<sup>112</sup> with the language from the Supreme Court's opinion in *Reiter* — that "the Supreme Court has implicitly rejected [this] portion of *Quittner*."<sup>113</sup>

Although most of the reported cases that have considered the impact of the bankruptcy policy favoring equal treatment of creditors on applying recoupment's "same transaction" test in bankruptcy have, like *Malinowski* and *Peterson Distributing*, made no mention of the Supreme Court decision in *Reiter*, we think that *Reiter* got it right. And here is why.

#### IV. THE ROLE OF PREFERENCE LAW, EQUITY, AND NON-BANKRUPTCY LAW

##### A. THE ROLE OF A "TRANSFER OF AN INTEREST OF A DEBTOR IN PROPERTY" IN PREFERENCE LAW

According to the Supreme Court in *Reiter*, recoupment "involves no element of preference."<sup>114</sup> Section 547(b) of the Bankruptcy Code sets out the elements of an avoidable preference, providing in part:

[T]he trustee may avoid any transfer of an interest of the debtor in property—

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt. . . .<sup>115</sup>

Don't miss the first element of a preference which comes before any of the numbered elements: "transfer of an interest of the debtor in property."<sup>116</sup> Recognition of a creditor's right of recoupment involves neither a "transfer" nor "an interest of the debtor in property."

110. 95 F.3d 1392, 1400 (9th Cir. 1996).

111. 202 F.2d 814, 816 (9th Cir. 1953).

112. *Newbery*, 95 F.3d at 1400.

113. *Id.* at 1398.

114. *Reiter*, 597 U.S. at 265 n.2.

115. 11 U.S.C. § 547(b)(1)-(2) (2000).

116. The House Report, explaining the purpose of section 547, "missed" this unnumbered element of a preference: "[T]he preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally." H. R. REP. NO. 95-595, at 177-78 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138. The qualifying words "as a result of a transfer of an interest of the debtor in property" should have been inserted after the word "payment" in the last sentence.

Assume, for example, that *C* is one of *D*'s unsecured creditors. *P*, *D*'s parent, pays *C*. Neither *D* nor *P* pays any of *D*'s other creditors. *D* then files for bankruptcy. It is at least

“Transfer” is broadly defined in section 101 of the Bankruptcy Code as “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor’s equity of redemption.”<sup>117</sup>

As a leading bankruptcy treatise puts more simply:

Put simply, “transfer” includes, for purposes of section 547(b), any event that results in eliminating or diluting the debtor’s interest in property. . . . A transfer occurs whenever the debtor’s interest in property is diminished by . . . action or by . . . operation of law. . . . [T]he meaning of “transfer” is probably sufficiently broad to encompass setoff. . . .<sup>118</sup>

While we can understand that a treatise with a co-author then in the “real world” practicing law might use a “weasel word”<sup>119</sup> like “probably,” we are in the unreal world of law school and so substitute the law student’s favorite word “clearly.” The meaning of “transfer” is clearly sufficiently broad to encompass a setoff. Consider again the most common setoff situation: *D* has 1000 in an account at *B* Bank. *D* then borrows 600 from *B* Bank. *D* defaults. Notwithstanding the loan and the default, *D* still has a complete and absolute property right in the 1000 in the bank account. It is only when *B* Bank exercises its right of setoff that *D*’s property right is reduced from 1000 to 400. *D*’s “interest in property is diminished by . . . operation of law.”<sup>120</sup> Setoff is thus within the Bankruptcy Code’s meaning of “transfer.”

This meaning of “transfer” is not, however, sufficiently broad to encompass recoupment. Consider the somewhat “clunky” example of recoupment recently used by the United States Court of Appeals for the First Circuit, with editing for substance and style in BOLD:

For example, if A were to buy a truck worth \$1000 from B [Change to **“to buy a truck for \$1,000 warranted to be in working condition”**],

---

arguable that *C* “received a greater payment than others of his class.” It is not even arguable that *C* received a section 547 preference.

117. 11 U.S.C. § 101(54).

118. 1 DAVID G. EPSTEIN, STEVE H. NICKLES & JAMES J. WHITE, *BANKRUPTCY* § 6-4 (1992). While “transfer” includes a setoff, section 547 does not include setoff. The only provisions that limit setoff are sections 362, 363, and 553 (“Except as otherwise provided in this section [553] and in sections 362 and 363 . . . this title does not affect. . . .”). 11 U.S.C. § 553. See Lynne P. Harrison & James J. DeCristofaro, *Bankruptcy Setoff and Recoupment*, 861 PRAC. L. INST./COMM. 467, 476 (2004) (“Setoffs under Section 553 are by their very nature ‘preferences’ that are sanctioned by the Bankruptcy Code.”). Cf. *In re Jenkins*, No. 03-60548, 2004 WL 768574, at \*3 (Bankr. S.D. Ga. 2004) (“While a setoff may seem to have the effect of a preference, ‘it is a long recognized right and is generally favored.’”).

119. Theodore Roosevelt once said in a speech in St. Louis on May 31, 1916, One of our defects as a nation is a tendency to use what have been called weasel words. When a weasel sucks eggs, it sucks the meat out of the egg and leaves it an empty shell. If you use a weasel word after another there is nothing left of the other.

BRYAN A. GARNER, *GARNER’S MODERN AMERICAN USAGE* 826-27 (2003).

120. 1 EPSTEIN, NICKLES & WHITE, *supra* note 117 and accompanying text.

but A finds that he must expend [spend<sup>121</sup>] \$100 to put the truck back into working condition, A might send B a check for only \$900. . . . Had B filed for bankruptcy protection, A could recoup the \$100 prepetition debt from B.<sup>122</sup>

In the First Circuit's truck hypothetical, B has a property right as a result of the truck transaction but B's property right is a right to be paid \$900. Even before A asserted any right of recoupment, B's right as a result of the truck transaction was only a right to be paid \$900.

As the United States Court of Appeals for the Fifth Circuit explained in *In re United States Abatement Corp.*,<sup>123</sup> "We have held that the trustee of a bankruptcy estate 'takes the property subject to the rights of recoupment.' In other words, to the extent that a party is entitled to recoupment of funds, the 'debtor has no interest in the funds.'"<sup>124</sup>

Accordingly, recoupment by A in the First Circuit's truck hypothetical is not an "event that results in eliminating or diluting the debtor's interest in property."<sup>125</sup> Recoupment is thus not a "transfer" as defined in Bankruptcy Code section 101. Recoupment is thus not a preference. The bankruptcy preference policy is not a reason for a more restrictive right of recoupment in bankruptcy.

121. According to Bryan Garner, "Expend is a formal word that often seems less appropriate than spend." BRYAN A. GARNER, *GARNER'S MODERN AMERICAN USAGE* 330 (2003).

122. *In re Holyoke Nursing Home, Inc.*, 372 F.3d 1, 3 (1st Cir. 2004). The First Circuit provided a similar but clearer example in an earlier opinion, *United Structures of Am., Inc. v. G.R.G. Eng'g S.E.*, 9 F.3d 996, 998 (1st Cir. 1993):

If Smith sues Jones for \$10,000 for grain that Smith supplied, and Jones seeks to reduce the judgment by \$5,000 representing Jones' expenditure [**not as bad as "expend," but still clunky**] to dry out Smith's (defectively) wet grain (or the cost of buying replacement grain, or the grain's lost value), Jones is seeking a *recoupment*.

See also the "recoupment scenario" in Craig H. Averch & Blake L. Berryman, *Getting Out of the Code: When Equitable Remedies Obtain Priority Over General Unsecured Claims*, 5 J. BANKR. L. & PRAC. 285, 287-88 (1996). *But cf. In re Slater Health Ctr., Inc.*, 306 B.R. 20, 25 (D.R.I. 2004) ("In basing its decision on recoupment analysis, the Bankruptcy Court overlooked the fact that the issue of recoupment arises only where there are two reciprocal obligations and it is necessary to determine whether one can be offset against the other. There is no need to consider recoupment when there is a single obligation to the debtor and the only issue is whether the amount in question must be deducted in order to calculate the sum owed to the debtor. In such cases, since the debtor has no claim to the amount in question, there is nothing that can be offset. Furthermore, the amount in question cannot be part of the debtor's estate.").

123. 79 F.3d 393 (5th Cir. 1996).

124. *Id.* at 398. In this quotation from the Fifth Circuit's *United States Abatement* opinion, the court quotes from its earlier opinion in *Holford v. Powers*, 896 F.2d 176, 179 (5th Cir. 1990). One page earlier in the Fifth Circuit's *United States Abatement* opinion, the court quoted from the Tenth Circuit's opinion in *In re B&L Oil Co.*, 782 F.2d 155, 157 (10th Cir. 1986) (recoupment "sometimes allows particular creditors preference over others") and from a bankruptcy court opinion in *In re Fiero Prods., Inc.*, 102 B.R. 581, 586 (Bankr. W.D. Tex. 1989) (A[R]ecoupment . . . is an exception to the rule that no creditor of a bankrupt shall receive preferential treatment."). *Id.* at 397.

125. 1 EPSTEIN, NICKLES & WHITE, *supra* note 117 and accompanying text.

## B. THE ROLE OF "EQUITY"

Some courts have used "equity" as a reason for a more restrictive right of recoupment in bankruptcy. Consider, for example, *In re University Medical Center*,<sup>126</sup> a case under section 362 of the Bankruptcy Code.

University Medical Center filed its Chapter 11 petition on January 1, 1988.<sup>127</sup> It owed the government for overpayments resulting from estimated payments pursuant to 42 U.S.C. § 1395(g).<sup>128</sup> The Third Circuit ruled that the automatic stay barred the government from recouping these overpayments.<sup>129</sup> In so ruling, the court stated the doctrine of recoupment must be narrowly construed in the bankruptcy context:

[B]oth debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations. Use of this stricter standard for delineating the bounds of a transaction in the context of recoupment is in accord with the principle that this doctrine, as a non-statutory, equitable exception to the automatic stay, should be narrowly construed.<sup>130</sup>

We have two problems with this statement and the proposition that "equity" supports a more restrictive right of recoupment in bankruptcy.

First, recoupment is not an "equitable exception to the automatic stay." Recoupment is not any kind of exception to the automatic stay. Recoupment is not within the scope of the automatic stay. The automatic stay is created by section 362. Paragraph (a) of section 362 describes the scope of the stay.<sup>131</sup> The automatic stay of section 362 does not bar all postpetition collection activities by creditors. Note the prefatory language in section 362(a): "stay of."<sup>132</sup> The stay only applies to actions covered by one of the numbered subsections in 362(a). Section 362(a)(1) and section 362(a)(6) require "a claim against the debtor."<sup>133</sup> Recoupment is not a "claim" against the debtor; it is a defense against the debtor's claim. Accordingly, neither section 362(a)(1) nor section 362(a)(6) stays recoupment.<sup>134</sup>

Other subsections of 362(a) stay only actions "against . . . property of the estate."<sup>135</sup> In recoupment, the property of the estate is the debtor's

---

126. 973 F.2d 1065 (3d Cir. 1992).

127. *Id.* at 1070.

128. *Id.*

129. *Id.* at 1069.

130. *Id.* at 1081.

131. 11 U.S.C. § 362(a) (2000).

132. *Id.*

133. *Id.*

134. See *In re Powell*, 284 B.R. 573, 576 (Bankr. D. Md. 2002) ("Conceptually, however, the automatic stay is not applicable. A defendant is not required to seek judicial approval prior to recoupment because the 'right of recoupment does not constitute a debt. . . .'""); see also Bruce H. White & William L. Medford, *Setoff vs. Recoupment: To Lift the Stay or Not, That Is the Question*, 22 AM. BANKR. INST. J. 18, 41 (2003) ("Thus, recoupment, in its doctrinal definition, is not a violation of the automatic stay because it is not an attempt to collect a debt.").

135. 11 U.S.C. 362(a)(2)-(4).

right to be paid limited by any right of recoupment. At the time of the debtor's bankruptcy filing, the right to be paid becomes property of the estate, already subject to any nonbankruptcy right of recoupment.<sup>136</sup> As the federal district court for the Southern District of New York recently explained, "Recoupment . . . is not subject to the automatic stay provisions of 11 U.S.C. § 362, 'because funds subject to recoupment are not the debtor's property.'"<sup>137</sup>

Second, we are concerned by the Third Circuit's use of the words "inequitable" and "equity." Numerous reported cases on recoupment in bankruptcy begin the discussion of recoupment with a statement such as "in light of the equitable nature of recoupment,"<sup>138</sup> suggesting (although never expressly holding) that the equitable nature of recoupment should restrict recoupment in bankruptcy. There is no more "equity" to recoupment in bankruptcy than to recoupment outside of bankruptcy. And, there is not that much "equity" to recoupment outside of bankruptcy.

Recoupment is based on the existence of a defense arising out of the same transaction as the plaintiff's claim. Recoupment does not create the defense; equity did not create the defense.<sup>139</sup> Equity's development of recoupment did not change the common law of contracts or torts—it did not create new substantive rights. Recoupment was merely the equity courts' innovation on the restrictions of common law pleading.

Courts outside of bankruptcy do not restrict a creditor's exercise of the right of recoupment because of the possible impact on the other party to the transaction or to third parties. The test for recoupment outside of bankruptcy is a "same transaction" test, not an "inequitable" test. Similarly, courts in bankruptcy should apply that same "same transaction" test in determining whether there is a right of recoupment. Bankruptcy courts should not restrict the right of recoupment because of the possible impact of recoupment on the debtor or other creditors.<sup>140</sup> There is noth-

---

136. As the Fifth Circuit has stated: "We have held that the trustee of a bankruptcy estate 'takes the property subject to the rights of recoupment.' In other words, to the extent that a party is entitled to have recoupment of funds, 'the debtor has no interest in the funds.'" *In re United States Abatement*, 79 F.3d at 398.

137. *Ferguson v. Lion Holding, Inc.*, 312 F. Supp. 2d 484, 502 (S.D.N.Y. 2004) (quoting *In re Malinowski*, 156 F.3d 131, 133 (2d Cir. 1998)). See also Donald S. Bernstein & Pamela Arnstein, *Current Developments: Setoff and Recoupment*, in 767 PRAC. L. INST., COM. L. AND PRAC. COURSE HANDBOOK SERIES, 371, 385-86 (1998).

138. See, e.g., *In re Malinowski*, 156 F.3d 131, 135 (2d Cir. 1998); see also *Sims v. United States Dep't of Health & Human Servs.*, 225 B.R. 709, 715 (N.D. Cal. 1998).

139. But see *Reab v. McAllister*, 8 Wend. 109, 115 (N.Y. 1831) ("There is a natural equity, especially as to claims arising out of the same transaction, that one claim should compensate the other, and that the balance only should be recovered. . . . But the common law of England required . . . separate actions. . . ."), as quoted in Michael Tigar, Comment, *Automatic Extinction of Cross-Demands: Compensation from Rome to California*, 53 CAL. L. REV. 224, 254 (1965).

140. But see *In re Fas Mart Convenience Stores, Inc.*, 296 B.R. 414, 422 (Bankr. E.D. Va. 2002) ("[T]he court is not in a position to determine whether or not McLane has a right of recoupment. However, even if McLane has a valid right to recoup, the court believes that the potential injury to debtors far outweighs the potential harm to McLane. . . .").

ing in the equitable nature of recoupment to support a more restrictive right of recoupment in bankruptcy.

Recall that setoff has the same equitable origins as recoupment. And, recall that section 553 of the Bankruptcy Code provides "except to the extent that the court . . . based on the equities of the case orders otherwise."<sup>141</sup> If the equitable nature of setoff supported a more restrictive right of setoff in bankruptcy, there would be no reason for such a provision in section 553. And, there is nothing in the equitable nature of bankruptcy to support a more restrictive right of recoupment in bankruptcy.

Bankruptcy courts are commonly described as being or having the powers of courts of equity. In 1939, in *Pepper v. Litton*,<sup>142</sup> the Supreme Court stated, "[I]n the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate."<sup>143</sup> Recent reported bankruptcy decisions contain similar statements. For example on June 24, 2004, a United States district court in *In re Cybridge Corp.*<sup>144</sup> stated: "Bankruptcy courts have long possessed equity jurisdiction in order to safeguard against unjust results."<sup>145</sup>

At the time of *Pepper v. Litton* in 1939, there was clear statutory support for such statements. Section 2 of the Bankruptcy Act of 1898 provided in pertinent part that "courts of bankruptcy . . . are hereby invested . . . with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings. . . ."<sup>146</sup> And in 1978 Congress enacted section 1481 of Title 28 which stated that a "bankruptcy court shall have the powers of a court of equity."<sup>147</sup> In 1984, however, when the provisions of title 28 were amended making the bankruptcy court a "unit" of the district court, section 1481 was repealed.<sup>148</sup> At the present time, unlike at the time of *Pepper v. Litton*, nothing in the Bankruptcy Code<sup>149</sup> or related statutes gives equity juris-

141. 11 U.S.C. § 553 (2000).

142. 308 U.S. 295 (1939).

143. *Id.* at 307-08.

144. 312 B.R. 262 (D. N.J. 2004).

145. *Id.* at 269. See also *In re DESA Holdings Corp.*, No. 02-11672, 2004 WL 316451, at \*2 (D. Del. Feb. 9, 2004) ("a bankruptcy court in passing on claims 'sits as a court of equity. . . .").

146. Act of July 1, 1898, ch. 541, § 2, 30 Stat. 544, 545, *repealed by* Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-151326.

147. *Celotex Corp. v. Edwards*, 514 U.S. 300, 328 (1995).

148. *Celotex*, 514 U.S. at 329.

149. There are cases that cite section 105 as statutory authority for using supplemental equitable principles in bankruptcy. *E.g.*, *In re Miller*, 377 F.3d 616, 621 (6th Cir. 2004) (equitable powers under section 105 support the granting of a partial discharge); *In re BLI Farms*, 312 B.R. 606, 620 (E.D. Mich. 2004) (equitable powers under section 105 support substantive consolidation). The senior co-author of this article (writing with another co-author with a name similar to "Nockles") has already written about section 105 and bankruptcy courts as courts of equity. Steve H. Nickles & David G. Epstein, *Another Way of Thinking About Section 105(A) and Other Sources of Supplemental Law Under the Bankruptcy Code*, 3 CHAP. L. REV. 7, 13-17 (2000) [It should be noted that I did not receive a



diction to bankruptcy courts that is different from or greater than the equity jurisdiction of a federal district court.<sup>150</sup>

And, even if there were a real and lawful basis for bankruptcy judges to assume the role of equity chancellors, such a role would not give them legitimate reason to change or restrict the law of recoupment. As one of the leading treatises on equity points out: "the broad and fruitful principles of equity have been established and can not be changed by judicial action."<sup>151</sup>

Consider again the first case considered in this article, *In re Holyoke Nursing Home, Inc.*,<sup>152</sup> the most recent United States Court of Appeals decision on recoupment in bankruptcy. There the debtor argued that even if there was a right of recoupment under nonbankruptcy law, "recoupment is an equitable doctrine, and therefore the case should be remanded to the bankruptcy court to determine the appropriate equitable balance to be struck. . . ."<sup>153</sup> The First Circuit properly rejected this plea for further equitable balancing to restrict the right of recoupment in bankruptcy,<sup>154</sup> and the First Circuit also properly rejected the notion that bankruptcy courts have some sort of a "roving commission to do equity."<sup>155</sup>

### C. ROLE OF STATE LAW AND OTHER NON-BANKRUPTCY LAW (HEREINAFTER "STATE LAW")

There are many hard questions about the role of State law in resolving disputes in bankruptcy.<sup>156</sup> The question of the role of State Law in resolving disputes in bankruptcy regarding recoupment is not one of those hard questions.

The Bankruptcy Code does not create a right of recoupment. The Bankruptcy Code does not even mention recoupment. If there is a right of recoupment in bankruptcy, it is based on State Law.

Compare again the Bankruptcy Code's treatment of recoupment and the Bankruptcy Code's treatment of setoff. While the Bankruptcy Code

generous grant for writing that article—perhaps it was because the title did not have a colon. I did receive a nice polo shirt with a "Chapman Law" logo that I still wear. DE]

150. See generally Honorable Marcia A. Krieger, *The Bankruptcy Court Is a Court of Equity: What Does That Mean?*, 50 S.C. L. REV. 275 (1999).

151. 1 JOHN NORTON POMEROY, EQUITY JURISPRUDENCE § 59 (5th ed. 1941). The Supreme Court made a similar point in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999), holding that the equity jurisdiction conferred on federal courts by the 1789 Judiciary Act did not empower a court to freeze assets for the benefit of creditors. The Court stated, "We do not question the proposition that equity is flexible, but in the federal system, at least, that flexibility is confined within the broad boundaries of traditional equitable relief." *Id.* at 332.

152. 372 F.3d 1 (1st Cir. 2004).

153. *Id.* at 4-5.

154. *Id.* at 5.

155. *Id.* (quoting *In re Ludlow Hosp. Soc'y, Inc.*, 124 F.3d 22, 27 (1st Cir. 1997)).

156. See generally Vern Countryman, *The Use of State Law in Bankruptcy Cases*, 47 N.Y.U. L. REV. 407, 631 (1972); Thomas E. Plank, *The Erie Doctrine and Bankruptcy*, 79 NOTRE DAME L. REV. 633 (2004).

does not create a right of setoff, section 553 in essence provides for a more restrictive right of setoff in bankruptcy. Congress could have used the phrase "recoupment or setoff"<sup>157</sup> in section 553 and expressly provided a more restrictive right of recoupment in bankruptcy, but it did not.

Bankruptcy Code restrictions on setoff in bankruptcy are consistent with other provisions of the Bankruptcy Code. Setoff involves two separate transactions: the debtor has rights against someone arising from one transaction and that nondebtor party is asserting rights against the debtor arising from a second, separate transaction. In general, the Bankruptcy Code treats each transaction separately. For example, the preference requirements of section 547(b) are applied separately to each payment to a creditor. Each debt owed to a creditor is tested separately under section 507 in determining the priority of that claim.

Similarly, the absence of Bankruptcy Code restrictions on recoupment is consistent with other provisions of the Bankruptcy Code. Recoupment involve rights from the same transaction. That transaction is the basis for the debtor's rights against the third party, the property of the estate.

While "property of the estate" is a phrase in section 541 of the Bankruptcy Code and section 541 uses the phrase "interests of the debtor in property," courts [and the Court] have looked to State Law to determine the "interests of the debtor in property."<sup>158</sup> Consider again the words of the Beatles and the United States Court of Appeals for the Fifth Circuit, "all that we are saying is"<sup>159</sup> "the trustee of a bankruptcy estate 'takes the property subject to the rights of recoupment [under State Law].'" In other words, to the extent that a party is entitled to recoupment of funds [under State Law], the debtor *has no interest* in the funds."<sup>160</sup>

## CONCLUSION

One of the nice things about doing this article is that it will be easy to gauge how persuasive these ideas are. Our goal is simply to eliminate reported opinions such as the Second Circuit's opinion in *In re McMahon*,<sup>161</sup> that first discusses "Recoupment Under New York Law"<sup>162</sup> and

---

157. Cf. U.C.C. § 9-340 (2000) (Effectiveness of Right of Recoupment or Set-Off Against Deposit Account).

158. 11 U.S.C. § 541 (2000).

159. John Lennon, *Give Peace a Chance*, on SHAVED FISH (Capitol 1975); lyrics available at [http://www.geocities.com/lyrics\\_archive/john\\_lennon/songs/Give\\_Peace\\_a\\_Chance.htm](http://www.geocities.com/lyrics_archive/john_lennon/songs/Give_Peace_a_Chance.htm)

Some readers may be puzzled by our linking the Beatles and the Fifth Circuit's statement on recoupment. At the height of the Beatles' popularity in the late 1960's, rumors spread that Paul McCartney had died in a car accident in 1966 and had been replaced by a look-alike. It was claimed that if you played the ending of "I Am the Walrus" backwards you could hear all the other Beatles saying "Paul is dead." [http://www.brainyencyclopedia.com/encyclopedia/p/pa/paul\\_is\\_dead.html](http://www.brainyencyclopedia.com/encyclopedia/p/pa/paul_is_dead.html). We of course believe that if you can figure out how to play a record backwards, what you will hear is the Fifth Circuit [not the Beatles] saying "recoupment is what we said."

160. *In re United States Abatement*, 79 F.3d at 398.

161. 129 F.3d 93 (2d Cir. 1997).

162. *Id.* at 96.

then separately discusses "Recoupment in Bankruptcy."<sup>163</sup>

Recoupment in bankruptcy is whatever recoupment is under state law. In New York bankruptcy cases, "recoupment in bankruptcy" is the same as "recoupment under New York law." If a bankruptcy court can not determine whether there are two apples or an apple and an orange, it can and should look not only to bankruptcy cases on recoupment but also to non-bankruptcy cases. Two apples outside of bankruptcy are two apples in bankruptcy. Anything else is a fruit basket turnover.

---

163. *Id.*